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VIEWS FROM CAMELBACK MOUNTAIN

Another Temporary Market Correction

The U.S. stock market hit an all-time high eight days ago with the Dow Jones Industrial Average reaching 26,952. Similar to the events of late January, we have experienced a sudden and sharp market decline with the Dow down more than 800 points yesterday and down 545 today. We believe the immediate cause of the recent declines is once again, the market reacting to higher interest rates. Rates on the 10-year Treasury recently reached 3.25% and the 30-year Treasury reached 3.4%.

As we had been expecting for over a year, the Federal Reserve raised the Fed Funds rate .25% on September 26th. They also telegraphed another increase in December and likely two or three increases next year. If they raise rates in December and twice in 2019, the overnight Fed Funds target will be 3% by the end of next year. It is hard to believe that if the Fed Funds rate is 3% the 10-year Treasury is priced correctly at 3.2% and it is particularly hard to believe that the 30-year Treasury is priced correctly at 3.4%. As we have written to you over the past year, we have been concerned that the bond market is out of touch with reality and was due for a big increase in rates.

The U.S. economy grew at a 4.2% annualized rate in the second quarter and will likely show about 3% growth for all of 2018. Corporate earnings will likely be up more than 20% this year and another 8-10% next year. Consumer confidence and most other economic data are at multi-year highs. Unemployment during September reached a 50-year low. Stock prices eventually follow earnings results from companies and we believe that is why the market hit new highs less than two weeks ago.

We believe that we are probably beginning another short-term market correction where stock prices will have to come to grips with the new reality of higher interest rates. Some companies will be impacted heavily, like home builders, utilities and other interest rate sensitive companies. Many companies' business performance will not be significantly influenced by higher rates. Some companies, several of which we own, will benefit from a higher rate environment.

The markets are also concerned with the President's trade wars. The market has finally figured out that the ultimate target is China where the President is trying to achieve somewhat more fair terms of trade. So far, China seems reluctant to embrace any changes. Longer term, we are confident that they will yield at least partially because the terms of trade and their behavior relative to technology and intellectual property is grossly unfair to the entire rest of the world. So far, China is losing the trade war. Even with yesterday's decline, the S&P 500 was up 4% for the year. The Chinese stock market is down more than 20% for the year. China cannot afford to continue a trade war for very long. Wilber Ross, our Secretary of Commerce, recently stated that China is "out of bullets" for the trade war. President Trump needs to be careful to balance his desire for better trade terms against the risk of throwing China into a significant recession. We remain hopeful that there are still a few adults in the White House to make sure we do not trigger a serious economic problem in China which could spread to already vulnerable Europe and Japan.

This correction is a bit different than the one we experienced in January and February. While they were both caused by higher interest rates, the current correction is more focused on technology and other very highly valued momentum stocks and may last a little longer than the January and February declines. Corrections often last three to nine months. We continue to believe that this is a temporary decline and that the U.S. economy and corporate America will continue to do just fine even if the 10-year Treasury yield rises to 4%-4 ½% and if the 30-year Treasury rate rises to 5%-5 ½%. We expect stock prices to recover relatively quickly. As a result, we are not suggesting any sales or other actions at this time. We think you will be best served to ride through what we believe will be a temporary period of weakness. We may get some opportunities to buy some really great companies at attractive prices, if and when we identify opportunities, we will contact you.

As always, if you have any questions, please call any of us here at L. Roy Papp & Associates.

Best regards,

Harry Papp

Harry Papp
Managing Partner
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